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FEDERAL INCOME TAX ASPECTS OF DAMAGES

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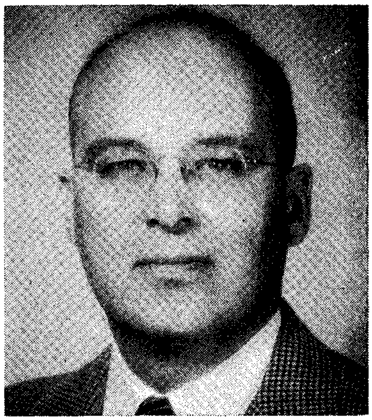

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A recent, responsible review of the law of damages begins with this sentence "Probably no branch of the law is more confused, less considered, or more often applied than damages."[1] A United States Supreme Court Justice who once had been Chief Counsel for the Internal Revenue Service described the tax law as "a field beset with invisible boomerangs"[2] and, on another occasion, as "so complex as to be the despair of judges."[3]

It is the boundary of these two distinctive fields of law which we propose to survey.[4] It ought to be an area of special interest to the general practitioner.[5] To him who is already in the case the litigant ordinarily will turn for advice and assistance concerning the tax consequences of a contemplated suit, a proposal of settlement or a favorable or unfavorable judgment. As for the tax specialist, his competence in his specialty depends on his knowledge of its points of contact with the various other branches of law, such as damages. A tax lawyer ignorant of general legal problems and principles is as handicapped as a general practitioner who does not recognize a tax problem when he sees it.

It is not the objective of this article, of course, to make a tax expert of anyone, even in the area under review and least of all to minimize the general practitioner's need for the cooperation of the tax specialist in specific instances and at crucial steps. Equally far from our aim is offering an exhaustive analysis and collection of authorities which will furnish a ready-made answer to any specific problem now puzzling a tax expert. Rather, it is our modest purpose to give recent illustrations of some actual tax problems which have arisen from litigation and caused enough difficulty to find a place in the reports; to place them in perspective; and to provide

[1] Developments in the Law—Damages, 61 Harv. L. Rev. 113 (1947).

[2] See Arrowsmith v. Commissioner, 344 U. S. 6, 12 (1952).

[3] See Dobson v. Commissioner, 320 U. S. 489, 498 (1944).

[4] For a trail-blazing article which covers the same territory, and more, see Plumb, Income Tax on Gains and Losses in Litigation, 25 Cornell L. Q. 221, 26 Cornell L. Q. 16 (1940). See also Mertens, Federal Income Taxation § 5.21 (1942); Note, Taxation of Damage Recoveries from Litigation, 40 Cornell L. Q. 345 (1955).

[5] "No other branch of the law touches human activities at so many points." Mr. Justice Jackson speaking for the Court in Dobson v. Commissioner, 320 U. S. 489, 494-5 (1944).

a readily available reference to the decisions and rulings which have dealt with those matters. Accordingly, the law as applied in given cases takes priority in the discussion over our own ideas of what it should be in the same cases, in unreported settlements, or in hypothetical situations. Finally, we usually have placed the emphasis on the principles which determine the answers rather than on the answers themselves.

As used herein, damages includes judgments and settlements interchangeably.[6] Those judgments and settlements relating to divorce and to the annulment of marriages, though forming a part of the general subject now under consideration, are governed by special rules and for that reason are excluded from the scope of the present discourse. The question *when* a reportable or deductible judgment for damages should be taken into account (involving such doctrines as accrual and constructive receipt) is likewise beyond the pale of our attention. For present purposes, but present purposes only, we indulge the pleasant assumption that all judgments are collectible by the creditor and payable by the debtor without great difficulty or delay.

In general, gains and losses suffered in litigation are not in a class by themselves. They are merely special instances of the actual or intended application of principles of federal income tax law which embrace other classes of gains and losses. It follows from this fact that the tax treatment of damages and settlements seldom, if

[6] Cf. Lyeth v. Hoey, 305 U. S. 188, 196 (1938), "We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound . . . ."

ever, depends on such common-law characterizations as torts, contracts and trusts. The important categories are those of the revenue law, and this means that the text of the applicable code should be kept in mind.

The code, it must be conceded, rarely contains a complete and final statement of the governing law, for here, even more than in the case of other statutes, the gloss of administrative rulings and court decisions is important. So true is this that it is difficult to say whether the code should be considered a starting point rather than a point of departure. Notwithstanding these reservations, the text of the code is at least a point of reference or orientation which should be kept in view, like a lighthouse, by all the legal mariners who seek the harbor of minimized taxes.

To conclude these introductory remarks, a litigant who has obtained a favorable, final judgment, or received money or other property in settlement of a suit, sometimes faces an adversary more formidable than the just vanquished, for the federal tax collector may insist on sharing with him the fruits of victory. As for the losing litigant, there are times when his loss, after taxes, may be substantially less than the full amount which must be or has been paid in satisfaction of a judgment or in settlement of a suit. The tax opportunities of the losing litigant will be considered later, in Part II.

PART I—FAVORABLE JUDGMENTS

As will be shown in more detail as we go along, a successful litigant may urge that his recovery: (a) is not comprehended within the broad concept of taxable income; (b) irrespective of possible inclusion within the statutory purview of gross income, the judgment is excluded from taxation by certain provisions of the code; or (c) the recovery is entitled to one of the various types of relatively preferential treatment specified in the present or the prior code, which ever is applicable under the circumstances.

Section 61 of the Internal Revenue Code of 1954, which is coextensive with corresponding provisions of prior statutes, sweeps "all income from whatever source derived" within the taxable ambit of gross income. There are statutory illustrations of various kinds of taxable income, but no statutory definition which may be used as a criterion or test for determining whether an apparent increase of wealth is real, is recognizable and is income. The opin-

[7] See Commissioner v. Glenshaw Glass Co., 348 U. S. 426, 431 (1955).

ions of courts are similarly devoid of any authoritative definition which may be used as "a touchstone to all future gross income questions."[7]

As indicated above, there are certain specific statutory exclusions from gross income. For example, section 102(a) of the present code provides, as did the corresponding section of the prior code, that "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." Section 104(a) contains the following additional provisions which are pertinent here:

> (a) In General.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—
>
> (1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;
>
> (2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness . . . .

Bequest or inheritance. In the leading case of *Lyeth v. Hoey,*[8] the Supreme Court of the United States ruled that a sum which a son of a deceased daughter of a decedent received in compromise of litigation attacking the validity of a will of the latter was protected from the grasp of the collector by the provision excluding the taxation of the value of property acquired by inheritance. The will had been drawn so as to benefit a charity at the expense of the taxpayer. The Court pointed out that the taxpayer's heirship underlay the compromise agreement. In a much more recent case, the Tax Court denied the protection of the statutory provision to a taxpayer who was unrelated to the decedent but who had received money in settlement of litigation based on the decedent's alleged contract to provide for the taxpayer, an employee, by will.[9]

Workmen's compensation. In *William L. Neill*[10] the taxpayer had not received what ordinarily would be considered a workmen's compensation award or judgment. The Tax Court, though doubting that the provisions relating to workmen's compensation "are literally applicable," gave the benefit of provisions comparable to those above quoted from section 104 to a policeman retired for disability incurred in line of duty. An earlier decision by the Court of Appeals for the District of Columbia[11] insisted on a more literal

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[8] 305 U. S. 188 (1938).
[9] John Davies, 23 T. C. 524 (1954).
[10] 17 T. C. 1015 (1951).
[11] Waller v. United States, 180 F.2d 194 (D. C. Cir. 1950).

application of the statutory language in question and a quite recent pronouncement of the Tax Court[12] seems to look more favorably on the restrictive decision of the Court of Appeals than on the Tax Court's own more liberal holding in the Neill case.

Personal injuries. The precise scope of the exclusion of recoveries received "on account of personal injuries" has not been spelled out in litigation or otherwise to the extent that might be expected. This may be the result of two factors: (a) In the past, perhaps more than will be true in the future, reliance has been placed on the limitations of, or implied exclusions from, the statutory income concept; and (b) revenue officials may have been reluctant to test out every conceivable legal possibility of revenue at the expense of an injured class whose net recoveries seldom are considered by its members as full compensatory however impressive gross recoveries may seem to others.

In *Joseph Frank*[13] the Tax Court found that the taxpayer had failed to establish that part of his recovery was based on an assault and on that ground the court denied him the benefit of the express statutory exclusion for personal injuries. An early decision by the Board of Tax Appeals, now the Tax Court, held that damages for libelling the taxpayer personally (not in his professional capacity) were not within the statutory income concept.[14] A recent administrative ruling placed the non-taxability of recoveries for wrongful death on the same basis.[15] It would seem that the latter ruling at least could have been rested on the provisions of the express exclusion of damages received on account of personal injuries. There is authoritative precedent from the field of general law for applying the evident policy and not merely the literal and express terms of a statute.[16] As we learn still elsewhere, "the letter killeth, but the spirit giveth life."

The interest *on* a personal injury judgment appears includible in gross income on the basis of an early decision.[17] Damages related to impaired earning capacity, past as well as future, *may* be entitled to the benift of the exclusion of items received "on account of personal injuries." Despite what is said in a moment about the absence of any implied exclusion of punitive damages, exemplary damages awarded in a personal injury case may be held within the exclusion from gross income expressed in section 104(a)(2) and its predecessors.

Punitive damages. In March 1955 the Supreme Court of the United States handed down a decision in the case of *Commissioner v. Glenshaw Glass Co.*[18] In that case the Supreme Court held that treble or punitive damages awarded in federal antitrust litigation were within the concept of income subjected to tax by section 22(a), the equivalent of the present section 61. In effect, the Court

[12] Charles F. Brown, 25 T. C. 220 (1955).
[13] 22 T. C. 945 (1954), *aff'd per curiam*, 226 F.2d 600 (6th Cir. 1955). Whether income taxes should be taken into account in fixing damages for personal injuries is, of course, a quite different question. Cf. Stokes v. United States, 144 F.2d 82 (2nd Cir. 1944) (no error in refusing to make a deduction for income taxes).
[14] C. A. Hawkins, 6 B. T. A. 1023 (1927).
[15] Rev. Rul. 54-19, 1954-1 Cum. Bull. 179.
[16] E. g., Keifer & Keifer v. RFC, 306 U. S. 381 (1939).
[17] Theodate Pope Riddle, 27 B. T. A. 1339 (1933).
[18] 348 U. S. 426. (1955).

held that the punitive damages constituted gross income and were not the beneficiaries of any implied exclusion from gross income. The Court pointed out that the Commissioner of Internal Revenue had published his non-acquiescence in a contrary decision which the Board of Tax Appeals had made in 1940 and consistently thereafter had asserted the taxability of such receipts.

Insider profits. On the same day that the Supreme Court decided the *Glenshaw Glass* case, the Court also ruled taxable the "insider profits" recovered by a corporation from a director who had dealt in the securities of the corporation.[19] With respect to such profits the Court said, "There is no indication that Congress intended to exempt them from coverage."[20]

Whether income or recovery of capital. It is the clear import of the two Supreme Court decisions just mentioned that all "gains" are includible in gross income unless specifically excluded. This still leaves open and at large the basic, bedrock question whether a given recovery is a "gain" or "income" or, on the contrary, is a recovery of capital. The answer to that question, as will be seen, may depend in considerable measure on what relief counsel has asked for in his pleading, the language of the agreement in compromise, and the proof presented on the respective trials. It may not be surprising, in view of the above-mentioned confusion in which the law of damages is enveloped, that the decision of this tax issue seldom has been made to turn on the nature of damages as a matter of stautuory or common law. In a recent case, however, in which a portion of a recovery in a partnership accounting was held capital, this factor was recognized as a favorable one to the taxpayer under the circumstances.[21]

(a) Recovery of capital. In *Durkee v. Commissioner*[22] the appellate court was asked to decide the taxability of a sum which the taxpayer, an electrical contractor, received in settlement of a tort action which charged the defendants with combining to injure the taxpayer's business. The court indicated its opinion that a portion of the settlement represented a recovery of a capital item, goodwill, and it remanded the case to the Tax Court for a

[19] General American Investors Co. v. Commissioners, 348 U. S. 434 (1955). See also Commissioners v. Lo Bue, 351 U. S. 243 (1956) (holding certain options to purchase stock to be income).
[20] General American Investors Co. v. Commissioner, 434.
[21] Specialty Engineering Co., 12 T. C. 1173 (1949). See Uniform Partnership Act § 42.
[22] 162 F.2d 184 (6th Cir. 1947). See also Farmers & Merchants Bank v. Commissioner, 59 F.2d 912 (6th Cir. 1932).

determination, among other things, of the unrecovered basis of the asset in question. The court was impressed by the fact that the taxpayer had made no claim for lost profits as such and had merely measured the damage to his goodwill by loss of income.[23]

In *Commissioner v. Pennroad Corp.*[24] the taxpayer's recovery of a large sum on trust principles, as a result of a stockholders' derivative suit, was held to represent capital instead of income. The suit which was settled had alleged a breach of trust in that investments of the taxpayer had been made for the benefit of another corporation rather than for the advantage of the taxpayer. Both the Tax Court and the appellate court agreed that the sums recovered stood in place of losses or impairments of capital which had been caused by the improper investment.[25]

(b) Recovery held income. In a recent case the Tax Court overruled the taxpayer's contention that sums received in settlement of an antitrust suit represented capital in part.[26] The complaint in the suit appeared to demand damages for lost profits rather than damages for injury to business in general and goodwill in particular. In *Mathey v. Commissioner*[27] the appellate court

[23] As for a tort resulting in the physical destruction of specific assets and another tort involving the impairment of property value, see and compare the two cases cited in footnotes 33 and 34 *infra*. Further, note the textual discussion to which the two footnotes pertain.

[24] 228 F.2d 329 (3d Cir. 1955).

[25] See also Ollie Beverly Rose, 8 T. C. 854 (1947).

[26] Chalmers Cullins, 24 T. C. 322 (1955).

[27] 177 F.2d 259 (1st Cir. 1949), *cert. denied*, 339 U. S. 943 (1950). See Avery Corp. v. Fugate, 129 Colo. 595, 272 P.2d 652 (1954) [state income case discussing a judgment rendered in Hyman & Co. v. Velsicol Corp., 123 Colo. 563, 233 P.2d 977 (1951)].

held taxable a damage recovery in a patent infringement suit. In doing so the court stated the rule applicable as follows:

> If it was brought to recover lost profits, the proceeds are taxable as income; if it was brought to recover for loss or damage to capital, the proceeds are non-taxable.[28]

In the early, leading case of *Burnet v. Sanford & Brooks Co.*,[29] the Supreme Court held includible in gross income a taxpayer's recovery on a dredging contract for breach of warranty of the materials to be dredged. It was held that the damages did not constitute capital even though, in a sense, they did no more than restore to the taxpayer a portion of the expenditures made in earlier years in partial performance of the unprofitable contract. The taxpayer was reporting income on a yearly rather than on a completed contract basis.

(c) Burden of proof. In a number of cases taxpayers have been denied the desired treatment of an item as capital in whole or in part because of a failure to establish to the satisfaction of the court that all or a definite part or proportion of a sum received as damages or in settlement was allocable to capital items, such as goodwill, rather than to profits. Possibly no other factor has been cited as often by the courts in recent years as a basis for treating the disputed item as income.[30] At least as early as the launching of the action for tort, breach of contract, breach of trust or whatever, the taxpayer should consider the ways and means of obtaining the maximum recovery after taxes. At the beginning of the litigation is the time to lay the groundwork which will enable proper proof to be made in any later tax dispute. Moreover, the basis of the assets alleged to have been damaged should be considered at the outset and later stages of the litigation.

Whether ordinary income or capital gain. By a statutory definition of general application a capital gain is one which arises from the sale or exchange of a capital asset.[31] Sometimes the facts are such that an "involuntary conversion" may be relied on in lieu of fulfilling the statutory prerequisite by the more common means

[28] But see note 1 *supra* at 181. Cf. Kane, Patent Law, 1954 Ann. Survey Am. L. 420, 422.

[29] 282 U. S. 359 (1931). See Sanders v. Commissioner, 225 F.2d 629 (10th Cir. 1955), *cert. denied*, 350 U. S. 967 (1956) (concerning tax character of money received in settlement of claims under construction contract).

[30] Cf. Phoenix Coal Co. v. Commissioner, 231 F.2d 420 (2d Cir. 1956) (failure of proof—complaint not controlling); Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir.) (basis not shown), *cert. denied*, 323 U. S. 779 (1944); H. Liebes & Co. v. Commissioner, 90 F.2d 932 (9th Cir. 1937); Chalmers Cullins, 24 T. C. 322 (1955).

[31] Int. Rev. Code of 1954, § 1222.

of a sale or exchange.[32] Thus in *Walter A. Henshaw*[33] a judgment attibutable to the negligent destruction of oil and gas in place was held to involve an "involuntary conversion" of the asset. Since the taxpayer had no unrecovered basis in the destroyed assets, he was taxable on the entire judgment but, under the circumstances, at the favorable rate applicable to a long-term capital gain. Damages awarded for slander of title appear to stand on a different footing.[34] They represent capital recoveries, but in the ordinary case at least would not be deemed to include gains, capital or otherwise.[35]

The case of *Sarah A. Young*[36] involved a special type of sale or exchange, that of stock surrendered to a corporation in return for corporate assets distributed in liquidation. Actually, the taxpayer had recovered a judgment in a stockholder's derivative suit. but, as the corporation had been liquidated, the judgment inured to the benefit of the taxpayer. The Tax Court held the judgment should be treated as so much received on liquidation of the corporation and be taxed accordingly. There being no unrecovered basis in the stock, the taxpayer in this case was taxable on the entirety of the judgment but as a capital gain, not ordinary income.

In several instances it has been held that a settlement of a seller's suit to rescind a sale of stock is tantamount to a sale of stock for tax purposes and that the sum received is subject to treatment as part of the purchase price.[37] A purchaser who sued for specific performance of the contract to sell but received cash in settlement of the suit was held to have made a sale or exchange of rights in a capital asset with the result that, like the sellers just mentioned, he was able to shield his receipt from treatment as ordinary income.[38] It is noteworthy, however, that in the latter case the taxpayer's right to purchase did not arise from an employment contract and did not constitute partial compensation for services performed.[39] In a case of the kind just mentioned, as in the case of a judgment on a note given for services, the receipt would be ordinary income.[40]

Whether judgment may be attributed to several years. In several recent cases taxpayers have sought to obtain for their settlements or judgments the benefit of the provisions permitting the attribution of income to several years. In one case the Tax Court turned down a claim that a sum received in settlement of a suit for breach of an employment contract deserved treatment as "back pay" under a predecessor of section 1303.[41] In another case the same court held the income item did not relate to services

[32] *Id.* § 1231.
[33] 23 T. C. 176 (1954).
[34] Highlands Farms Corp., 42 B. T. A. 1314 (1940).
[35] See note 23 *supra* together with the pertinent text regarding recovery of capital, and see note 44 *infra* with the related text concerning the usual necessity of a sale or exchange as a prerequisite to capital gain treatment.
[36] 16 T. C. 1424 (1951).
[37] Albert J. Goldsmith, 22 T. C. 1137 (1954) (overruled Government argument that "severance pay" was involved); Margery K. Megargel, 3 T. C. 238 (1944). *But see* Frank T. Feagans, 23 T. C. 208 (1954) (no sale of capital asset, but, rather, a collection of compensation).
[38] Quincy A. Shaw McKean, 6 T. C. 757 (1946).
[39] Cf. Albert C. Becken, Jr., 5 T. C. 498 (1945).
[40] Matilda S. Puelicher, 6 T. C. 300 (1946).
[41] Estate of Lester O. Stearns, 14 T. C. 420 (1950), *aff'd per curiam*, 189 F.2d 259 (6th Cir. 1951).

performed, as required by the provisions invoked, presenting section 1301.[42]

Realization of gain deferred — condemnation — reorganization. The present code, like the one which preceded it, contains provisions spicificallly directed to condemnation and threats or imminence of it. The purpose of the provisions is to permit any gain resulting from the seizure or sale of property in such circumstances to be deferred, or, perhaps, depending on later events, avoided altogether.[43] In a different type of case a taxpayer succeeded in having a gain on the surrender of judgment claims held a "non-taxable transfer" (i.e., the realization of gain deferred).[44] He had surrendered the claims to the debtor in consideration of the issuance to him of stock of the debtor, a transaction which gave the taxpayer and other judgment creditors control of the corporate debtor within the meaning of section 112(b)(5), a section of the old law relating to non-taxable reorganizations.

Judgment collected by assignee — deferred collection — "tax-benefit" rule. A purchaser of a judgment who collects upon it is not deemed to have made a sale or exchange of the judgment.[45] Any gains on such transactions, therefore, are taxable as ordinary income. In the well-known *Dobson* case,[46] the Supreme Court held that the Board of Tax Appeals had committed no error of law in

[42] Curtis B. Dall, 23 T. C. 580 (1954), *aff'd per curiam*, 228 F.2d 526 (2d Cir. 1955).

[43] Int. Rev. Code of 1954, § 1033. For examples of the application of the "involunatry conversion" section of the prior law, see Gaynor News Co., 22 T. C. 1172 (1954); Leon Strauss, 22 T. C. 140 (1954); Rev. Rul. 55-170, 1955-1 Cum Bull. 342.

[44] Alexander E. Duncan, 9 T. C. 468 (1947). *Compare* Int. Rev. Code of 1954, § 351, *with* Int. Rev. Code of 1939, § 112 (b) (5).

[45] Galvin Hudson, 20 T. C. 734 (1953), *aff'd per curiam sub nom.* Ogilvie v. Commissioner, 216 F.2d 748 (6th Cir. 1954).

[46] Dobson v. Commissioner, 320 U. S. 489 (1943).

applying the "tax benefit" rule—a rule which is now embodied in section 111 of the code.

According to the decisions of the Board of Tax Appeals in the *Dobson* and other cases a judgment or cash settlement obtained by a purchaser of stock on the basis of fraud perpetrated by the seller of the stock is required to treat the receipt as ordinary income if in a prior, closed year the stock was sold, a loss taken and a tax benefit received. The receipt is income only to the extent of the tax benefit or deduction derived from the loss taken in the closed year. If no benefit were obtained from any such deduction, the subsequent recovery of judgment for fraud in the sale transaction would include no income. There are evident distinctions between the *Dobson* case and the *McKean* case[47] discussed above, but new cases may arise in which it will be difficult to determine which or what rule should govern.

Interest. The includibility in gross income of interest on a personal-injury judgment already has been mentioned.[48] In several instances, too, the portion of a judgment labelled interest has been recognized as includable in gross income.[49]

PART II—ADVERSE JUDGMENTS

A litigant who has suffered an adverse judgment or made a payment in settlement of a suit does not *ipso facto* become entitled to an income tax deduction. Under the Internal Revenue Code of 1954, as under prior law, certain liabilities and payments are deductible and others are not; some items are deductible from gross income without reservation and others are deductible to a limited extent only.

Business expense. One of the best known deductions is that of business expenses. Section 162(a) of the present code provides that "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" are deductible.

It seems abundantly clear that a bus company should be permitted to deduct the amount paid in satisfaction of a judgment for personal injuries which were caused by the company in the course of its business. The Tax Court has so held.[50] However, in the case of an individual who paid a sum in settlement of a judgment obtained against him because of an automobile accident, the same court denied a deduction of the sum paid as a business expense since it appeared the vehicle was being used at the time of the collision on the business of the taxpayer's employer.[51] Had the accident occurred during a trip made in the course of the individual taxpayer's own business, the holding doubtless would have been otherwise.[52]

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[47] See note 38 *supra.*

[48] See notes 14 and 17 *supra,* and related text. *But see* Helvering v. Drier, 72 F.2d 75 (D. C. Cir. 1934) ("interest" plus payment by Mixed Claims Comm. did not equal basis of property taken).

[49] Kieselbach v. Commissioner, 317 U. S. 399 (1943) (interest on condemnation award); W. H. Kiser, 12 T. C. 178 (1949) (held no interest included in partition decree); Ollie Beverly Rose, 8 T. C. 854 (1947).

[50] Virginia Stage Lines, Inc., 16 T. C. 557 (1951).

[51] Emanuel O. Diamond, 19 T. C. 737 (1953).

[52] Anderson v. Commissioner, 81 F.2d 457 (10th Cir. 1936).

In the recent case of *Mid-State Products Co.*,[53] the corporate taxpayer was denied the deduction of a sum paid by it in settlement of a suit in which the corporation and its president were co-defendants. The suit, brought by a stockholder, had charged the president with mismanagement and "milking" of the corporation. Under the settlement, the president acquired the shares of the complaining stockholder. Accordingly, the court took the position that the taxpayer's payment was not made for corporate purposes or "in carrying on any trade or business" of the taxpayer. In another proceeding in which the corporate stake in a controversy involving the officer was shown to be greater, a different result was reached. [54]

A trustee who *personally* paid a sum of money in settlement of an action brought against a trust employee who had made a fatal attack on a third person was not permitted to deduct his payment either as a business expense or as a loss.[55] The payment was held not to be a business expense of the taxpayers personally. In the absence of a showing that reimbursement from the trust was impossible or impractical, the court was unwilling to allow the sum paid to be deducted as a loss.

In *Hales-Mullaly v. Commissioner*,[56] a corporate taxpayer paid out a considerable sum in settlement of a suit in which it was joined as a co-defendant with its organizers and promoters and a number of its employees. The suit charged fraud and a conspiracy to pirate the business of the camplainant-competitor. In addition to relying on the position that the payment did not relate to carrying on the taxpayer's business, the court of appeals said of the expenditure, "It is not ordinary."[57] The corporation's own liability, if any, was extraordinary, according to the court, in that it depended on the exceptional factor of the corporation's retention of the fruits of the fraud of others, to-wit, its organizers. In passing on the same facts and a similar question concerning state income taxes, the Oklahoma Supreme Court came to a contrary conclusion.[58]

That an adverse judgment in private litigation is based on fraud has been held insufficient, per se, to make the payment an extraordinary expense.[59] Indeed, not all penalties for public wrong-

[53] 21 T. C. 696 (1954).
[54] Catholic News Publishing Co., 10 T. C. 73 (1948).
[55] Charles D. Whitney, 13 T. C. 897 (1949).
[56] 131 F.2d 509 (10th Cir. 1942).
[57] *Id.* at 512.
[58] Protest of Hales-Mullaly, Inc., 186 Okla. 693, 100 P.2d 274 (1940).
[59] Helvering v. Hampton, 99 F.2d 358, 360 (9th Cir. 1935).

doing are denied deductibility. In 1954, the Commissioner of Internal Revenue finally agreed with the courts, or came close to agreeing with them, when he ruled that penalties for violations of OPA regulations are deductible if the violations were neither intentional "nor the result of the failure to take practical precautions."[60]

Nevertheless, it is fair to say that the words "more or less legal" have been interpolated into the above-quoted provisions of section 162(a) at some point by those who administer and apply that section.[61] For example, a payment made by a cement company in settlement of a non-civil antitrust proceeding brought against it by the State of Texas was held non-deductible as a business expense in *Universal Atlas Cement Co.*,[62] despite that taxpayer's denial of guilt in connection with the settlement. So also was a deduction denied in *William F. Davis, Jr.*[63] with respect to "insiders profits" paid to a corporation. Though a number of its members dissented in the *Davis* case, the Tax Court held that a deduction of such a payment, whether as a business expense or a loss, would frustrate a well-defined national policy.

In another case which involved "insiders profits" the taxpayer's obligation to disgorge was less clear but a payment was made in

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[60] Rev. Rul. 54-204, 1954-1 Cum. Bull. 49. But cf. Julain Lentin, 23 T. C. 112 (1954), *aff'd*, 226 F.2d 695 (7th Cir. 1955), *cert. denied*, 350 U. S. 934 (1956) (penalties for willful OPA violations held non-deductible). See generally Annot., 20 A. L. R. 2d 600 (1951).

[61] But cf. Commissioner v. Heininger, 320 U. S. 467 (1943); Commissioner v. Doyle, 231 F.2d 635 (7th Cir. 1956).

[62] 9 T. C. 971 (1947), *aff'd per curiam*, 171 F.2d 294 (2d Cir. 1948), *cert. denied*, 336 U. S. 962, (1949).

[63] 17 T. C. 549 (1951).

settlement of the possible liability. In this case, the Tax Court was willing to allow a deduction of the payment either as an expense or a loss.[64] In *Commissioner v. Macy,*[65] the beneficiaries of certain testamentary trusts filed objections to the accounts which the taxpayers, as trustees, had presented for judicial approval. There was no charge of bad faith. Without admitting liability but in order to settle the contested matters, the taxpayers consented to a surcharge of their accounts and placed personal funds, in an amount equal to the surcharge, to the credit of the principal accounts of the trust estates. The payment was held deductible as a business expense both by the Tax Court and on appeal.

Capital expenditure.[66] In the last of the foregoing cases one of the rejected arguments of the Commissioner was that the payment credited to the principal of the respective trusts was a capital expenditure and thus not deductible. In another recent case the Tax Court overruled a government contention that a payment made in settlement of a suit for commissions, damages for breach of contract, and similar items, actually represented the purchase price of an interest in a patent.[67]

The Commissioner is more likely to favor the position that a

[64] William L. Butler, 17 T. C. 675 (1951).
[65] 215 F.2d 875 (2d Cir. 1954). Accord Great Island Holding Corp., 5 T. C. 150 (1945).
[66] What constitutes a capital expenditure, like what constitutes a capital recovery, a question discussed in Part I, pertains to the whole income tax system, the entire code rather than any particular section. This is tantamount to saying that the distinction between income and capital and between capital expenditure and revenue charges entails recourse to what may be called "the common law of taxes."
[67] Camloc Fastener Co., 10 T. C. 1024 (1948).

payment is a capital expenditure than is the taxpayer. Such was the situation in the cases just mentioned.[68] However, in *James E. Caldwell & Co.*[69] it was the petitioner which wanted to have one of its payments so classified. The payment in question had been made in settlement of a suit which had been brought against the taxpayer by a judgment-creditor of its president for the purpose of setting aside an alleged fraudulent conveyance. The Tax Court held, with several members of the court dissenting, that the taxpayer could not add the payment to the basis of the property for the purpose of computing a gain on the sale of the property.

Non-business expense. In *Samuel G. Swaim*[70] a taxpayer had paid part of a commission claimed by a real estate broker, but had done so without admitting liability, merely to avoid litigation. The Tax Court held that the sum so paid was spent to conserve property and so was deductible as a non-business expense. The language of the governing section of the current code, section 212, corresponds with that of the prior law except that it has been broadened to provide expressly for the deduction of certain expenses relating to taxes. Section 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection or refund of any tax.[71]

In a case in which the facts were essentially similar to those in the *Macy* case discussed above, the taxpayer claimed a deduction as a non-business expense. The Tax Court's decision granting the deduction was reversed on appeal by the same appellate court which later considered the *Macy* case.[72] In the latter case the court of appeals did not overrule its prior decision expressly, it at all, but distinguished the two cases on the basis of the section of law invoked by the respective taxpayers. However, it would seem more reasonable, in the ordinary case of a non-professional trustee (as all these appear to have been), to grant such a deduction as a non-business expense and to disallow it, if at all, as a business expense.

A taxpayer who purchased a release of a claim made against him under the warranty provisions of a deed was denied the right to deduct the payment either as an ordinary loss or as a non-business expense.[73] The Tax Court held the payment was deductible only in the limited way prescribed for capital losses. The transaction of sale and conveyance which had occurred a few years earlier than

[68] See also Levitt & Sons, 5 T. C. 913 (1945), *aff'd per curiam*, 160 F.2d 209 (2d Cir. 1947).
[69] 24 T. C. 597 (1955).
[70] 20 T. C. 1022 (1953).
[71] Int. Rev. Code of 1954, § 212.
[72] Julius A. Heide, 8 T. C. 314 (1947), *rev'd*, 165 F.2d 699 (2d Cir. 1948). For discussion of the general relation between business and non-business expense, see Bingham Trust v. Commissioner, 325 U. S. 365 (1945).
[73] Estate of James M. Shannonhouse, 21 T. C. 422 (1953). But cf. Samuel G. Swain, 20 T. C. 1022 (1953).

the payment aforesaid was capital in nature and, according to the holding of the court, imparted its character as such to the adjustment made under the warranty contained in the deed.

Capital loss. In the case just described the court relied on the holding of the Supreme Court in the *Arrowsmith* case.[74] In the latter case, the taxpayer had paid a judgment given against a liquidated corporation of which he was a transferee. Several years earlier, at the time of the liquidation and in connection with it, the taxpayer had reported a capital gain and had paid the tax for the year accordingly. The Tax Court had considered the payment of the judgment as a fully deductible ordinary loss. The Supreme Court differed. In a decision from which three justices dissented the Supreme Court held that the loss fell squarely within the definition of "capital losses" contained in the sections pertaining to such losses—the necessary sale or exchange presumably being the one which had occurred for tax purposes at the time of the liquidation. This view of the situation meant a much smaller deduction for the taxpayer than would have been allowed under the ruling of the Tax Court.

Some years before, the Supreme Court had held that a capital loss occurred when a vendee's interest in real estate constituting a capital asset was cut off by a foreclosure sale.[75] According to the Court, the sale on foreclosure, though involuntary, was a sale within the meaning of the capital-loss provisions then in force. Moreover, the sale rather than the decree on foreclosure was held to be the definitive event establishing the loss. The principle of the case doubtless is broad enough to cover the ordinary foreclosure of mortgagors' interests in capital assets.

Ordinary loss. In many instances a losing litigant or other taxpayer seeking to deduct a judgment or other payment makes the alternative claim that it is either an expense or an ordinary loss. Whenever either type of deduction is allowable at all, it is allowable in full, but, as would be expected, the respective sections differ in language and to some extent in coverage. The text of section 165 of the current code resembles that of prior provisions and, so far as here pertinent, reads as follows:

[74] Arrowsmith v. Commissioner, 344 U. S. 6 (1952). For current capital loss provisions see Int. Rev. Code of 1954, § § 1211-12 & 1222.
[75] Helvering v. Hammell, 311 U. S. 504 (1941).

In the case of an individual, the deduction under section (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.[76]

While there is no express statutory limitation on the losses deductible by corporations, certain limitations have been implied. For a reason not explained in the court's opinion, the facts of the Hales-Mullaly case discussed above did not justify an ordinary loss deduction. It may be, as a subsequent Tax Court decision implies, that an essential condition for deducting a corporate loss resulting from a settlement is an approved degree of relationship between the corporate business and the loss.[77] Moreover, as in the case of an expense, an ordinary loss deduction appears subject to the implied condition that it is not generally allowable, either to an individual or to a corporation, with respect to an adjudged fine, penalty or the like.[78]

At times, as indicated earlier, an ordinary loss deduction may be denied on the ground that the loss in question is more appropriately described by the statutory provisions relating to capital losses.[79]

SUMMARY

The foregoing, of course, is no more than introduction to certain common phases of the law of federal income taxes. It is hoped, however, that the elementary nature of the study will be one of its chief merits. To suggest solutions for all likely situations, even if possible, would be to place the cart before the horse. In tax law as elsewhere, the solution of a specific problem depends upon its recognition and that in turn is conditioned upon an understanding of the general nature of the various types of problems which have been, and thus may be, encountered in litigation. If the present article contributes to such an understanding—to such a recognition of problems and possibilities—it has served its purpose. Particular solutions, like heaven, can wait. Besides, something should be left to litigation!

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[76] Int. Rev. Code of 1954, § 165.

[77] James E. Caldwell & Co., 24 T. C. 597 (1955) (2d question presented).

[78] See notes 60, 61, 62 and 63 *supra*, and related text. Cf. United States v. Algemene Kuntzijde Unie, N. V., 226 F.2d 115 (4th Cir. 1955) deduction of loss denied as contrary to national policy); Fuller v. Commissioner, 213 F.2d 102 (10th Cir. 1954) (loss deduction denied because of state policy).

[79] It should be noted, too, that the ordinary loss and bad debt provisions are mutually exclusive. Spring City Foundry C. v. Commissioner, 292 U. S. 182 (1934). A non-business bad debt results in a capital loss. Int. Rev. Code of 1954, § 166 (d). Cf. Thomas Lonergan Trust, 6 T. C. 715 (1946) (unusual question whether payment of a judgment against a decedent was deductible by the trustee as currently distributable income reportable by the beneficiary under the provisions relating to trusts; deduction disallowed).